BRIEF ANALYSIS
FY 2006 OMB MID-SESSION REVIEW

PREPARED BY: DEMOCRATIC STAFF, SENATE BUDGET COMMITTEE

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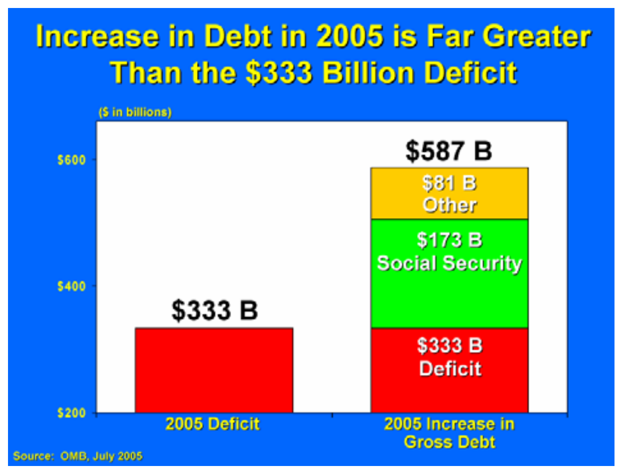
Short-Term Fiscal Improvement Masks Long-Term Deterioration

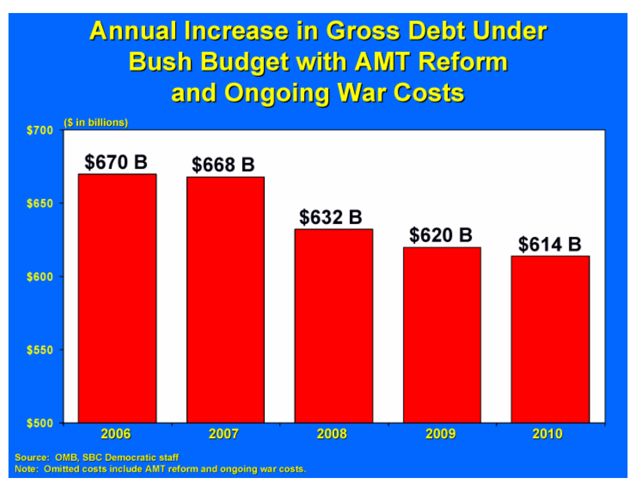
The Bush administration's FY 2006 Mid-Session Review shows a short-term fiscal improvement that masks the long-term deterioration in the nation's budget outlook. It is good news that this year's deficit is lower than last year's record. But this is hardly a time for celebration.

Federal Debt Continues to Pile Up

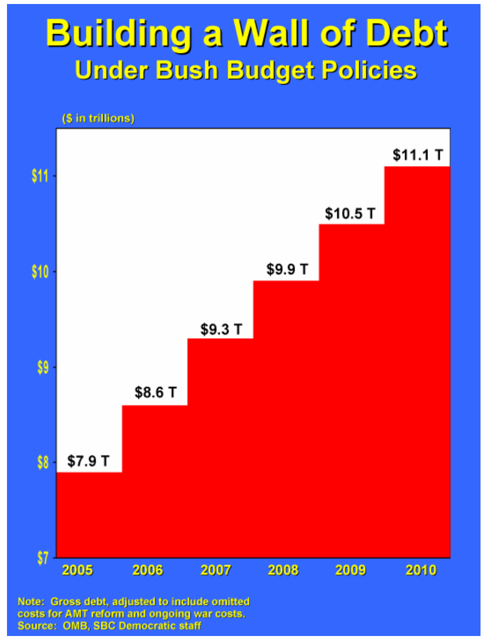
The Office of Management and Budget projects that the FY 2005 deficit will be $333 billion. While there is some improvement in the deficit projection for 2005, the debt continues to pile up. When we add in the Social Security and other trust fund dollars also being spent, the debt in 2005 will actually increase by $587 billion – not the $333 billion deficit advertised by the administration. By using Social Security surpluses to pay for tax cuts and other government spending, the administration significantly understates the true fiscal imbalance this year.



Over the five years covered by the Mid-Session Review, the debt being added is far greater than the deficit levels being projected. When we factor in the cost of Alternative Minimum Tax (AMT) reform and ongoing war costs, we can see that gross debt will increase by more than $600 billion every year during the budget window.



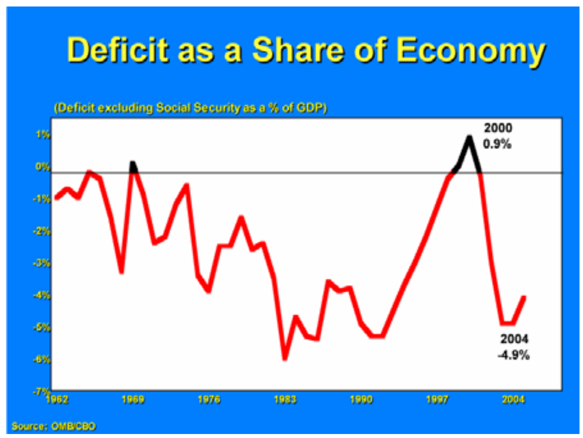
The reality is that the administration's policies are building a wall of debt. Under the assumptions noted above, gross federal debt will climb from $7.9 trillion in 2005 to $11.1 trillion in 2010.



To cover this borrowing, we are going deeper and deeper into debt to foreign countries. Japan, China, the Caribbean Banking Centers, and the United Kingdom are now the largest foreign holders of our debt. We are becoming increasingly reliant on foreigners to buy our debt and finance our deficit spending. Since the Bush administration took office, foreign holdings of U.S. debt have increased 97 percent – climbing from $1.01 trillion to $1.99 trillion.

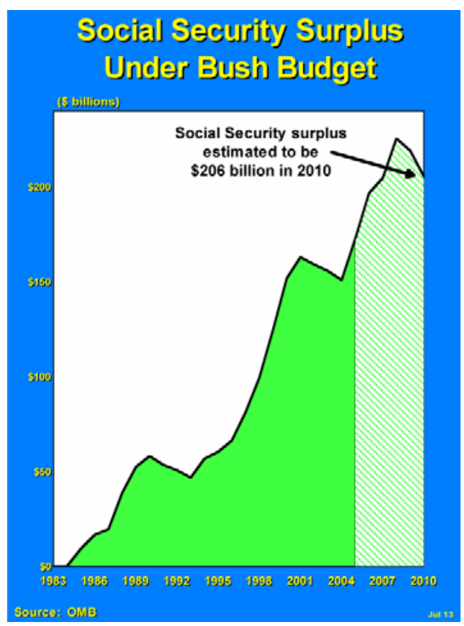
2005 Deficit Level Is Nothing to Cheer About

Although a $333 billion deficit in 2005 represents an improvement when compared to last year's record $412 billion deficit, it is still the third largest deficit in U.S. history.



Even when measured as a share of the economy, the 2005 deficit is nothing to cheer about. When Social Security is excluded, we see that the operating deficit in 2005 is really $505 billion, or 4.1 percent of GDP. In 2004, the deficit excluding Social Security was 4.9 percent of GDP.

We need to remember that when we reached a deficit of 6 percent of GDP in the 1980's, there was virtually no Social Security surplus to mask the deficit. Now, the Social Security surplus is projected to be $206 billion in 2010. By spending Social Security surpluses on tax cuts and other things, the administration is masking the true size of the deficit.



(NOTE: This chart shows how the Bush administration proposal to divert Social Security payroll tax dollars into private accounts will begin to shrink the Social Security surpluses after 2008.)

Large Costs Are Still Being Omitted

The administration did include some costs in its Mid-Session Review deficit projections that it had previously omitted. For example, the projections now include $50 billion in war costs in 2006, as well as $76 billion in costs in 2009-2010 to account for the initial years of the President's plan to create private accounts in Social Security. (NOTE: The $76 billion figure does not include the forgone interest to the Social Security trust fund associated with the President's private accounts plan. The loss of interest will further reduce annual Social Security surpluses and Social Security trust fund balances, absent any other programmatic changes.)

However, it is clear that the administration is still omitting large costs from its calculations. According to CBO estimates, ongoing military operations in Iraq and the ongoing war on terrorism could cost an additional $201 billion over the next five years and $333 billion over the next ten years.

And the administration's deficit projections still fail to account for the cost of reforming the AMT so that it does not become a middle-class tax trap. Because no resources were provided in the budget to reform the AMT, the number of taxpayers hit by the AMT could rise from 3.6 million today to 29 million by 2010. In essence, the administration is relying on this additional AMT revenue – primarily coming from middle-class taxpayers – to claim lower deficit totals in the years ahead.

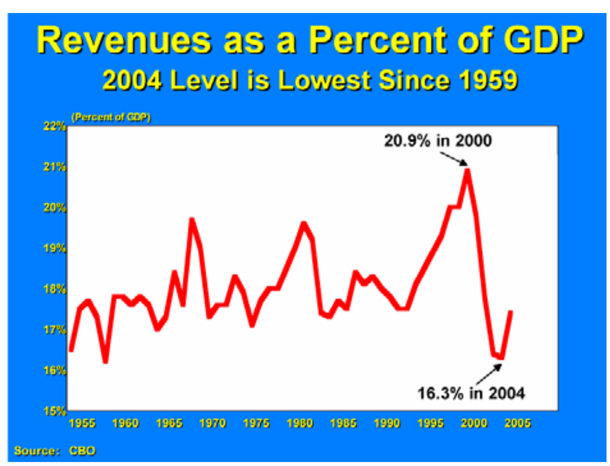
When omitted costs are factored in and the Social Security surplus is excluded, we see that annual deficits over the next five years never fall below $481 billion and total more than $2.5 trillion.

Projected Budget Deficits Under Bush Administration Policies – as of July 2005

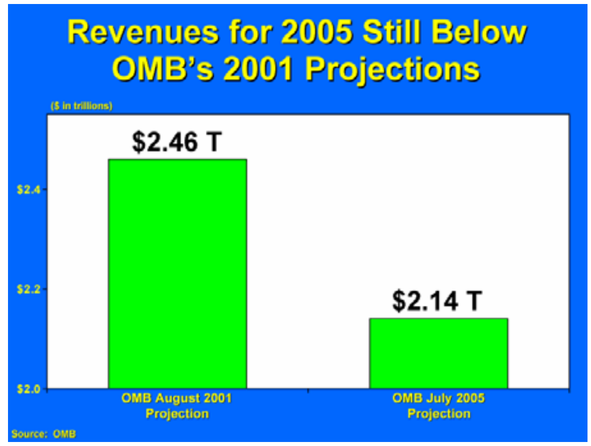
$ billions	2005	2006	2007	2008	2009	2010	2006-10
Deficit Projection	-333	-341	-233	-162	-162	-170	-1,067
Omitted Costs							
Ongoing War Costs	0	-13	-56	-60	-43	-29	-201
AMT	0	-12	-32	-39	-48	-57	-187
Debt Service	0	-1	-3	-8	-14	-19	-45
Total Omitted Costs	0	-25	-90	-108	-105	-105	-433
Social Security Surplus	173	197	205	225	219	206	1,052
Adjusted Deficit w/o Social Security	-505	-562	-529	-495	-486	-481	-2,552

Should Not Count on Revenue Increase Continuing

The improved revenue projections for this year are encouraging. But revenues as a percent of GDP are still down dramatically. In 2004, revenues as a percent of GDP fell to just 16.3 percent – the lowest level since 1959. This year, revenues as a percent of GDP are projected to equal 17.4 percent.



It is important to note that the new projection for revenues in 2005 is still far below the administration's 2001 projection for the year. In August 2001 – after the passage of the President's first large tax cut – the administration projected that revenues would equal $2.46 trillion in 2005. Instead, revenues this year are now projected to reach only $2.14 trillion.



It is also too soon to know whether the revenue increase will continue. Many economists have noted that the revenue spike has stemmed from temporary factors, such as the expiration of the business bonus depreciation tax cut, that are unlikely to carry forward. The Wall Street investment firm Goldman Sachs recently wrote the following in an economic report:

> *"As we see it, the prospects for additional cyclical reduction are limited...*
>
> *"The 2005 tax bonanza has been concentrated in final settlements of 2004 tax liabilities. This is why it suddenly appeared in April and May... Thus, the lion's share of this year's extra tax receipts reflects last year's strong profits and stock market.*
>
> *"Profit taxes account for most of the remainder. Over the first eight months of the fiscal year, corporate tax payments have risen 47%, again due to last year's surge in corporate profits. To the extent taxes have been paid on this year's profits, the strength may also reflect expiration of the depreciation bonus...*
>
> *"Conditions are not conducive to another April surprise next year... Unfortunately, the stock market has gone sideways thus far in 2005. Moreover, although economic growth remains sturdy, it has slowed – to about 3.5% from 4.4%. In this environment, gains in corporate profits...are apt to moderate as well."*

Congressional Budget Office Director Douglas Holtz-Eakin similarly cautioned against assuming that this year's improvement changes the nation's long-term budget outlook. He was quoted in the *Washington Post* stating the following:

> *"I do hope people are taking this with a grain of salt and not thinking this is 1998 all over again. There's simply no question if you take yourself to 2008, 2009, or 2010, that vision is the same today as it was two months ago."*

It would be a mistake to conclude that our fiscal problems are behind us. We continue to face serious long-term budget problems that must be addressed. Instead of celebrating, we should be focusing on finding real, bipartisan solutions – that address all of the budget challenges before us – to put our fiscal house back in order.

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